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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	

REPLY
OF
THE LINCOLN TELEPHONE AND TELEGRAPH COMPANY

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EXECUTIVE SUMMARY

In its initial comments in this proceeding, Lincoln commended the Commission for adopting price cap regulation and urged it to make the changes necessary to take telecommunications into the next century. Numerous other parties also filed comments in support of price cap regulation. However, some commentors attempt try to turn the clock back on price cap regulation by encouraging the continuation of certain regulatory constraints that limit the LECs ability to compete. Other commentors argue for an increase in the productivity offset based on the erroneous assumption of excessive earnings despite the fact that price cap LEC earnings are below the earnings levels of AT&T and other firms. In support of this position, MCI and AT&T place flawed short term studies on the record in an attempt to show that LEC productivity is higher than what LECs actually experienced. Lincoln believes that the Commission must consider its pro-competitive policies when evaluating the productivity offset. This means that the LECs must be provided the opportunity to offer new and innovative competitive services.

Lincoln believes that the record does not support a one-time adjustment in price cap LEC rates because of interest rates or increased earnings. This would be an inappropriate tie to traditional rate of return regulation.

Finally, Lincoln urges the Commission to implement fair regulation. This means that the LECs must be provided with the ability to match competitive offerings to meet customers requirements and ensure that the marketplace has the ability to choose the most efficient provider of service.

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The Lincoln Telephone and Telegraph Company ("Lincoln"), by its attorneys, hereby submits its reply in the above-captioned proceeding. In these comments Lincoln urges the Commission to provide the Local Exchange Carriers ("LECs") sufficient incentives to upgrade network infrastructure and compete in the marketplace. Lincoln also strongly supports the reply comments filed by the United States Telephone Association ("USTA") in this proceeding.

I. INTRODUCTION

In its initial comments, Lincoln commended the Commission for adopting price cap regulation and urged the Commission to make the necessary regulatory modifications to take telecommunications into the next century. Many other parties also filed comments in this proceeding. Some commentors sought to use price cap regulation as a means to obtain an even greater advantage in the marketplace, while others through self-serving, superficial, and circular arguments attempt to corrupt the price cap plan in order to derive short term financial benefits. Lincoln again urges the Commission to take a broad view of its long term goals for the telecommunications industry and not be diverted by commentors who only focus on certain issues in order to bias this proceeding.

II. LECs are Vital to the Information Infrastructure

The introduction of new telecommunications technology and services provides a clear opportunity to provide the U.S. public with numerous social and economic benefits. It is for this reason that there currently is a concerted effort in this country to develop a National Information Infrastructure ("NII"). The LECs are well situated to assist in bringing the benefits of the NII to the public. Lincoln does not believe that there is any valid public interest reason to use price cap policies as a means to impose an artificial impediment on the LECs ability to develop and implement the NII. Rather, any such policies would be directly counter to the policy goals underlying the NII.

Nevertheless, the Ad Hoc Telecommunications Users Committee ("Ad Hoc") asserts that price cap policies should not be designed to stimulate LEC investment in telecommunication infrastructure[1] as a means to foster the introduction of the NII.[2]

Ad Hoc argues that the NII is only a "marginal enhancement" to the Nation's telecommunication system[3] and that the capital to be dedicated to NII might be better invested in education, health, and other social programs.[4] As Ad Hoc must recognize, building the NII is much more than a "marginal enhancement". It can provide all Americans, not just big business, with the opportunity to participate in the information age. Connecting customers to hospitals, clinics, schools and libraries is an investment in education, health and the future that will clearly serve the public interest. In fact, it may be the best investment in education and health care that the United States can make.[5] Denying LECs the ability to generate capital needed for

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[1] See Ad Hoc Comments at 7.

[2] Id. at 12. Ironically, Ad Hoc also asserts that the purpose of regulation is to foster a competitive outcome. Therefore, if competition should result in the building of the NII and the purpose of regulation is to foster a competitive outcome then by Ad Hoc's own rationale it would seem appropriate for the Commission to stimulate investment in the NII.

[3] Id. at 3 and 12.

[4] Id. at 7.

[5] Ad Hoc's assertion that building the NII is a marginal enhancement is tantamount to calling the replacement of the dirt roads and single lane highways of yesterday with the interstate highway system that Americans enjoy today a minimal or nonessential enhancement.

such investment will only prevent the benefits of the information age from being provided to all consumers in an economic and efficient manner.

III. **Productivity Offset**

The commentors who argue for an increase in the productivity offset (or X Factor) generally point to an increase in price cap LEC earnings and then characterize these earnings as excessive.[6] LEC earnings have not been excessive. In fact, recent stock price performance would indicate that LEC earnings have been far below investor expectations. A composite measure of RBOC and GTE shareholder returns since 1991 show that price cap LEC returns[7] have been only 60% of the Standard & Poors ("S&P") 500 composite return. Lincoln's aggregate return over this time period has been less than 50% of the S&P 500 composite return. Commentors who attempt to mislead the Commission into believing that price cap LEC earnings are excessive only compare earnings to a traditional rate of return earnings benchmark because other comparisons clearly show that earnings are not excessive. The Commission stated that price cap regulation is a departure from traditional rate of return regulation with price cap LECs assuming more risks for the

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[6] See MCI Comments at 24, AT&T Comments at 23, GSA Comments at 8, and Ad Hoc Comments at 23.

[7] Shareholder returns are calculated as the change in stock price from 1/1/91 to 6/1/94 plus dividends paid.

possibility of more rewards.[8] Therefore it is inappropriate to measure earnings solely against a traditional rate of return earnings benchmark developed prior to the adoption of price cap regulation. As risk increases so must opportunities for price cap earnings or the capital markets will invest in other businesses. A truer measure of earnings reasonableness would be a comparison of LEC earnings to AT&T and S&P 400 company earnings. AT&T's reported 1993 rate of return was 13.49% and the S&P 400 median return from 1991 through 1993 was 14.92%. The aggregate 1993 price cap LEC return of 12.93% is below the returns reported by these comparable firms. Some commentors also fail to mention that price cap LECs have much lower depreciation rates than AT&T and other firms. This further demonstrates the reasonableness of price cap LEC's earnings.[9]

The MFS Communications Company, Inc. ("MFS"), a competitive access provider ("CAP") that should be concerned about the ability of price cap LECs to fund capital investments through excessive earnings, notes that price caps has worked well at controlling the overall level of earnings and caused price cap LECs to reduce their costs.[10]

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[8] Price Cap Performance Review for Local Exchange Carriers, Notice of Proposed Rulemaking, 9 FCC Rcd 1687 (1994), ("Notice") at paras. 11-12.

[9] LEC earnings are already below the reported earnings of AT&T and other firms despite the fact that LEC earnings are overstated for comparison purposes.

[10] See MFS Comments at 2.

Several commentors attempt to use their excessive earnings arguments to place highly misleading studies on the record to show that the productivity offset should be increased. Analysis of these studies show that they are superficial, incorporate methodologies previously rejected by the Commission and rely heavily on the premise that LEC earnings as compared to a traditional rate of return benchmark have increased since the adoption of price cap regulation.

MCI, in its comments, attempts to show that the productivity offset should be at least 2.0% higher by taking a Commission study of short term LEC productivity in common line and traffic sensitive services from 1984 to 1990 and further shortening the study period by removing the 1984 data point.[11] MCI merely rehashes its arguments that the 1984 data point should be removed because it does not fit the trend of the other data points.[12] In previously rejecting MCI's arguments regarding the 1984 data point, the Commission concluded that the 1984 data point provides important information regarding LEC productivity.[13] MCI also does not average its short term results with any long term study in accordance with the methodology used previously by the Commission.[14]

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[11] See MCI Comments at 21-22.

[12] See MCI Comments at 21.

[13] Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order ("Price Cap Order"), 5 FCC Rcd 6786, 6801 (1990).

[14] Price Cap Order at para. 97.

The use of a long term study tempers the volatility of a short term study and gives credence to the sustainability of the resulting productivity offset. MCI attempts to bolster its arguments with a distorted view of price cap earnings levels. As discussed supra, LEC earnings have not been excessive and MCI provides no new information that proves that the 1984 data point does not provide important information regarding LEC productivity.

AT&T also argues for a substantial increase in the productivity offset based upon another fatally flawed short term indirect study. AT&T asserts that a study analyzing only Regional Bell Operating Company ("RBOC") data is valid for all LECs.[15] This statement is erroneous and without merit. RBOCs operate in many large urban areas and are as much as 70 times the size of Lincoln. In addition, this study only encompasses three years and, as discussed infra, is not a fair or true measure of LEC productivity. This study uses price cap earnings as compared to a traditional rate of return benchmark to derive an excessive productivity offset. As discussed supra, it is misleading to even compare price cap reported earnings to a traditional rate of return, much less use this comparison to derive a productivity offset. Earnings are highly volatile and do not measure productivity and should not be relied upon to calculate a productivity offset. AT&T further biases the study by not accounting for all cost shifts that occurred during the study period as was done by the Commission in

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15 See AT&T Comments at para. 24.

its short term study[16]. This is nothing more than a blatant attempt to recapture efficiency gains made by LECs since entering price cap regulation. The Commission has indicated in the Notice that for incentives to work properly the productivity factor should not be changed to recapture all profits.[17]

MCI's removal of a single data point and AT&T's use of a three year study does point out a problem with short term studies. The Commission previously recognized that short term studies are very sensitive to the number of data points.[18] Also, short term studies do not take into account complete business cycles. In order to minimize this problem and develop a more equitable productivity offset, the Commission averaged a short term study with a long term study. In this analysis the Commission did not solely rely upon the result of its long term study. The long term study did not make adjustments for complex cost shifts and relied heavily on pre-divestiture data.[19] In its comments, USTA proposed a total factor productivity ("TFP") study performed by Christiansen Associates ("Christiansen Study") that eliminates the shortcoming of the two studies used to set the current productivity offset[20]. The Christiansen Study provides a number of improvements over other

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16 See Price Cap Order at 97.

17 See Notice at para. 45.

18 See Price Cap Order at para. 97.

19 Id. at para. 98.

20 See USTA Comments at 81.

studies or analysis in this proceeding. For instance, it encompasses nearly twice as many data points as does the study advocated by MCI. It also is a direct measure of total company productivity that does not need to be adjusted for cost shifts between jurisdictions. Finally, it does not include any pre-divestiture data. This direct study of LEC productivity post-divestiture indicates that the productivity offset should be 1.7%. Based on this analysis the productivity offset should be set at 1.7% to reflect the correct level of LEC productivity. This analysis demonstrates that there is no policy reason to increase the productivity offset to the exorbitant levels advocated by some parties in this proceeding.

Most of the comments agree that full and fair competition should gradually replace regulation. If this policy goal is to be successfully implemented, productivity cannot be examined in isolation. The Commission needs to take into account the fact that there is more competition today than when the current productivity offset was developed.[21] Moreover, the Commission must examine its own pro competitive policies, and congressional competitive mandates when it considers revising the productivity offset. Also, the Commission should consider that as competition increases, LEC depreciation rates will need to be based more on economic asset lives. This will further reduce reported earnings. These facts

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[21] See Teleport Communication Group Inc. ("Teleport") Comments at 1 and MFS Comments at 6.

clearly do not support an increase in the productivity offset and actually indicate that the correct value is lower than the current offset of 3.3%.

When Lincoln elected to enter price cap regulation, it did so under a set of assumptions. One of these assumption was a productivity offset that was reasonable despite the fact it was higher than that historically achieved by LECs. Another assumption was that if a LEC exceeded this higher productivity level it would be rewarded with increased earnings. Now, the Commission has indicated a belief that the productivity offset should be increased[22] because the price cap LECs met the challenge of a higher productivity offset and realized a modest increase in earnings. As discussed supra, certain comments argue for precipitous and harmful increases in the productivity offset, increases that would force Lincoln's rates down at twice the rate of inflation.[23]

The productivity offset must not be changed without consideration of its long term impact. The effect of the productivity offset compounds itself in each annual filing because of the way the LEC price cap plan functions. This compounding effect will magnify increases in the productivity offset. Therefore an increase, that may seem minor in the short term, will

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[22] See Notice at para. 45.

[23] The inflation component of the price cap plan, GNP-PI, was at 2.8% in the last price cap filing and is estimated to be at this level for the foreseeable future. This is compared to the productivity offset advocated by some commentors of between 5% and 6%.

substantially reduce future revenues. An increase in the productivity offset would simply gut the incentives from the price cap plan adopted by Lincoln. Financial commitments to shareholders and customers must continue to be met and an increase in the productivity offset may very well prevent this from happening. This is particularly important for smaller LECs who are more vulnerable to increases in productivity offset.[24] A productivity offset needs to be reasonably attainable over a long period not just for one, two or three years. Otherwise, the LECs will not have the proper incentives to upgrade their networks and compete in the new emerging telecommunications environment. For all the above reasons, Lincoln urges the Commission to temper the fervor of those seeking a productivity offset increase with calm consideration of the marketplace realities faced by all price cap LECs.

IV. A One-Time Adjustment

Some commentors argue that the Commission should make a one-time downward adjustment to price cap LEC rates, generally citing lower interest rates and increased earnings.[25] As discussed supra, LEC average earnings have been below that of AT&T since the adoption of price cap regulation. Since the interexchange market is competitive enough to ensure flow through

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[24] For instance, Lincoln is significantly smaller than most of the price cap companies. It operates in only one metropolitan area, has fewer economies of scales and has a significant number of rural subscribers.

[25] See AT&T Comments at 30 and MCI Comments at 28.

interest rate reductions, this is clearly at odds with commentor assertions that LECs did not flow reductions in capital costs through to their customers. As the level of earnings indicate, LECs have passed lower interest rates on to their customers because of lower GNP-PI values that reflect the lower interest rates. These comments are not surprising given the tendency by certain parties to argue in favor of rate of return methodologies that lower LEC rates and vehemently protest against rate of return methodologies that raise LEC rates. Price caps regulation is not some form of rate of return regulation as suggested by commentors.[26] Therefore, it is no longer appropriate to drag the burden of rate of return regulation into price caps.

V. Fair Regulation

Generally, all parties in this proceeding agree that the goal of regulation is to achieve a competitive result. A competitive result allows the consumer to select the most efficient provider of a service. This is not what occurs today. LEC competitors argue that the Commission should continue to keep LEC prices artificially high and deny LECs the ability to match competitive offerings. This type of restraint only harms consumers by continuing to foster pervasive market inefficiencies. In this environment, LEC competitors do not have to be efficient or the low cost provider of service, they merely need to beat the uneconomic

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[26] See Ad Hoc Comments at 4.

rates of the incumbent LEC. LEC competitors apparently do not want competition, they want the exclusive right to provide services to select high volume users. The standards proposed by LEC competitors for adopting streamlined regulation are excessive and contrary to previous Commission decisions. Teleport, for instance, argues for the use of The Herfindahl-Hirschman Index ("HHI") to determine market power.[27] Teleport provides an example that appears to show that the current interexchange market is more than twice as concentrated as a market warranting streamlined regulation.[28] This is contrary to previous Commission findings. Applying this test in order to determine if regulation in a market should be streamlined is ludicrous. A price cap LEC would need to lose more than 70% of their business before receiving any form of regulatory relief.[29]

MFS goes as far as to ask the Commission to provide LEC competitors with unit cost for every LEC rate element.[30] This is nothing but a blatant attempt to gain access to confidential pricing information that would give LEC competitors an even greater advantage in the marketplace than they currently enjoy. The comments filed by Teleport, MFS and others in this proceeding show

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[27] See Teleport Comments at 17.

[28] Id. at 18.

[29] To derive this number, Lincoln calculated what market share a LEC would need, assuming five other competitors each with equal market share, to derive an HHI index below 1800 as suggested by Teleport. See Teleport Comments at 18.

[30] See MFS Comments at 18.

that the Commission can no longer rely on competitors to regulate price cap LECs but should increasingly rely on competition in the marketplace. The best way to achieve a competitive result is to maintain the current price ceilings, remove the price floors and allow LECs to match competitive offerings. Price ceilings will prevent LECs from harming one class of customers in order to benefit another. The removal of price floors will give all consumers the ability to experience lower rates. The ability to match competitive offering will allow LECs to meet the needs of its customers and give the marketplace the ability to choose the most efficient provider of service.

VI. CONCLUSION

Lincoln again urges the Commission to take a realistic long term view of the telecommunications industry. Certain commentors attempt to obfuscate the issues through the use of short term, superficial and misleading data and studies. The Commission has the opportunity in this proceeding to ensure that every American has the ability to participate in the information age by maintaining an equitable price cap plan and allowing full and fair competition.

Respectfully submitted,

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